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Nothing symbolizes Japan's bubble economy, or its subsequent long slump, more than real estate. Now, after dropping by as much as 70%, real estate prices are ticking up, signaling a renewed Japanese economy.

A major restructuring of the nation's financial system, along with an injection of foreign capital and the introduction of publicly traded real estate investment trusts, are driving the real estate revival, according to Wharton faculty and real estate analysts working in Tokyo. "The no-growth swamp is over. Not only is real estate coming back, but it's coming back strong," says Wharton real estate professor Susan Wachter (http://www.wharton.upenn.edu/faculty/wachter.html).

For the first time in 16 years, land prices rose in Japan's top three markets -- Tokyo, Osaka and Nagoya -- during the 12 months that ended in July. Commercial land prices were up 2.6% while residential property was up 0.4%. In addition, new development is visible in Tokyo, rents are on the rise and investors are returning to the market.

Speaking at the fall members' meeting of the Samuel Zell and Robert Lurie Real Estate Center (http://realestate.wharton.upenn.edu/) at Wharton, Michael Pralle, CEO of General Electric's $48 billion real estate unit, said Japan is his top pick among current global real estate hot spots, including China, India and Germany.

GE has been in Japan since 1998 and owns $3 billion in real estate assets, including 120 office buildings and 9,000 residential units. Last year, it formed a partnership with Shinsei Bank to increase its holdings. "We like Japan a great deal," said Pralle, noting that GE is drawn to Japan by strong yields, attractive land prices that are still near 25-year lows, tax advantages and improving economic conditions overall.

According to Wachter, because real estate is viewed as a long-term asset, renewed confidence in the industry reflects optimism about the long-term prospects for Japan's economy. "The structure of Japan, Inc. has been substantially reformed and there is no going back at this point."

In addition to banking and other financial reforms, Wachter says a key element of today's interest in real estate is the government's willingness to abandon politically popular, but economically unjustified, public works projects in rural and agricultural areas. As a result, a drain on government spending has been eliminated, and more deserving projects in urban areas will receive more support. "There's no more business as usual," says Wachter. "This is a long-term structural reallocation that will not only affect Tokyo, but also the second-tier and even third-tier cities."

The Rise of REITs

Another driver of the real estate recovery is the same cure that was used for the United States' real estate crash following the savings and loan collapse of the 1980s: real estate investment trusts. Japan enacted new laws creating real estate investment trusts, known as J-REITs, in 2001. Now there are more than 30 J-REITs in operation with assets of $30 billion.

Nomura Real Estate Holdings raised the most money in an initial public offering of any Japanese company this year, trading up as much as 13% during its first day of trading in October. Nomura's debut topped the record set a month earlier by the Nippon Commercial Investment Corp., a real estate investment trust of Pacific Commercial Management.

Andrey Pavlov, a visiting professor of real estate at Wharton, explains that because REITs can be exchanged at any moment, managers are responsive to the market. Better response to market conditions helps prevent disconnects between supply and demand that lead to boom and bust cycles in real estate. "REITs are a great source of capital because they provide fairly-priced financing and there is a lot of discipline due to that immediate and direct connection to shareholders," says Pavlov.

Concerns are overblown that investors in REITs will be able to pull out abruptly if they unexpectedly need access to their capital, forcing REIT managers to unload long-term assets at what might be a low point in the market, he adds. "That's typically not a problem. REITs get the money from investors to buy the assets but the REIT itself is unaffected. There is no cash flow change."

REITs in Japan, and elsewhere, are a better way to finance real estate than bank lending, Wachter notes. Banks often structure deals with incentives or fees that encourage lending, leading to transactions that are often not aligned with market demand.

REITs also are structured with tax incentives that tend to draw international capital to Japan and other markets, she notes. REITs pool money from the sale of stock and use that to make investments in real estate. The shareholders then receive dividends paid out of profits earned by the REIT on rents or property sales. The dividends are not taxed.

For example, Nippon Building reported a 37% rise in net income to 9.85 billion yen ($84 billion) for the six months ending in June. The REIT paid out a record dividend of 19,391 yen, up from 17,046 yen for the same period a year earlier.

Wachter also points out that REITs are not closely correlated to the stock market and can provide balance for institutional portfolios, another draw for foreign capital. Finally, REITs bring transparency and better analysis to the market in which true value is often hard to gauge because shopping malls and office buildings, even homes, don't come up for sale everyday. "Once the funds are large enough, then you can have analysis with an entirely new level of sophistication, which again brings discipline," says Wachter.

The Japanese mortgage market is also moving toward greater securitization which will give investors another reason to invest, Wachter adds.

Following World War II, Japan created the Government Housing Loan Corp. (GHLC), to provide easy residential financing for homeowners. During the bubble years, as housing prices skyrocketed, Japanese homeowners were offered numerous types of exotic mortgages, including a 100-year mortgage to be paid off by the borrower's grandchildren.

As part of the nation's economic reforms, GHLC in 2001 was converted from an issuer of loans to a packager of mortgage-backed securities. By 2003, GHLC had securitized $8 billion in Japanese mortgages. Next year a new agency, the Japan Housing Finance Services Agency modeled on Fannie Mae in the United States, will begin securitizing loans written by private financial institutions.

Poised for the Future

Richard Georgi, a guest lecturer in real estate at Wharton and managing partner of Grove International Partners, a global private equity firm, estimates that Japan's economy bottomed out in 2002 and 2003. While hopes of earlier recoveries based on fiscal and monetary stimuli were subsequently dashed, Georgi says the current optimism is deserved because the government and the Japanese people have made significant changes to their economic system. "We are now starting to see some emerging growth patterns that we think are sustainable because they are on the back of real reform," says Georgi, who is based in Tokyo.

Rents are starting to tighten in Tokyo, which Georgi notes is double the size of Manhattan and four times the value. "This is a supertanker economy, so small changes can result in huge movements of capital."

As the nation's deflationary spiral comes to an end, interest rates will likely continue to rise. As that happens, investors sitting on yen-denominated Japanese government bonds will seek new asset investments. The capital-starved real estate industry will make an attractive investment, Georgi predicts, adding that the rest of the developed world has been in recovery for some time and is now priced high. Other countries, he says, will need to work off a real estate bubble created after the sharp interest rate declines that followed the September 11 terror attacks. "Japan is poised for future growth, although it is still at a low base compared to historic norms."

Foreign investment has played a part in Japan's recovery, but will not be a dominant force going forward, Georgi suggests. Changes in the nation's postal saving system, he notes, could free up vast pools of household savings that will flow into real estate. "Foreigners are here, and they have been playing a role in injecting liquidity into the market. But the most important transformation looking ahead will be the return of domestic capital to the real estate market," says Georgi.

Yasuhiko Watanabe, senior advisor at Mitsubishi Estate Co., says the Japanese real estate revival started in spring 2005. Vacancy rates for Class A office space in central Tokyo are now less than 1%, compared to 4% to 6% a year ago. Rents in the desirable Marunouchi district, located between Tokyo Station and the Imperial Palace, are up 20% from a year ago. "Probably we are now in a position to worry a bit about too much too soon," he says.

Japan's strong corporate comeback and infusions of domestic and international capital are feeding the real estate resurgence, says Watanabe, who also cautions that excess liquidity in the global economy could set off a financial crisis if the system experiences a shock. "The market could lose its steam if, for any reason, today's high level of liquidity becomes vulnerable. Geopolitical risks as well as financial and economic risks might play a significant role in the outlook for the market."

In addition to the new REIT investment vehicles, Eric Perraudin, managing partner of Japan Management Consulting in Tokyo, says ultra-low interest rates are contributing to the recovery. Investors can borrow 80% of the value of a building with a non-recourse loan at a rate of 2%. At the same time, building regulations governing the density of buildings have been eased, allowing developers to build more space on less land.

Pavlov warns that despite confidence in the real estate turnaround, the Japanese economy is still in a delicate state and policymakers will need to steer a careful course between stimulating growth and guarding against inflation. "As the economy picks up there will be more demand for real estate," he says. "It is very important that, in the face of the up-tick in demand, there is sufficient availability of funding, whether its bank loans, equity investment or private investment. You don't want to be in a credit crunch. Even if people want to buy and develop real estate, if they can't get the financing, nothing happens."

According to Pavlov, there is often a fine line between too little credit and too much. "Let me emphasize that you should never stimulate or encourage policy with the availability of cheap or under-priced financing. It has to be fairly priced," he says. "But you want to make sure lenders and other sources of capital don't overreact to the previous crash and stop lending altogether. There needs to be a golden balance between sufficient financing and not under pricing.... It's not an easy thing to do."

Perraudin notes that prices for commercial buildings have recovered about 30% to 50% from the bottom reached in 2002-2003. However, the gains are concentrated in Central Tokyo, Central Osaka and Nagoya. In other major cities, the market is flat, and small cities and rural areas are still experiencing declines. "Demand for real estate in central areas is limited," he says. "Demographics are bad, with the Japanese population and workforce shrinking."

He points out that land prices in some regions are still artificially high, propped up by subsidies for agricultural use and ownership of property by debt-ridden public institutions and governments.

John Percival, a Wharton adjunct finance professor, says that despite all the reforms that have been made in Japan, real estate is likely to remain cyclical. While companies and financial institutions have undergone major reforms, there remains more cross-shareholding between banks and other businesses than in the United States and much of the rest of the world. "Real estate is coming back," says Percival, "but that's the good news and the bad news. If there's another bubble, then we'll go through this whole process all over again."

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